The Federal Report

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

The Month in Washington: January 2007

Congress slowed to a halt for the customary lull until the State of the Union address, where the President used his final speech to call for more attention to his priorities. As typically occurs, the courts and regulators picked up the pace of activity as legislation entered its doldrums. The Courts ruled on diverse matters from the *Stoneridge* case to Medicare coordination and age discrimination while regulators continued to press companies on executive pay. Congress enacted new provisions under the Family and Medical Leave Act as part of the Defense bill signed by President Bush. Prompted by a substantial hiccup on Wall Street, Washington finally noticed the slumping economy and devised a stimulus plan that some critics see as having dubious value and others view as incomplete.

Issues and Events

Supremes Say No to Third Party Recovery

The Supreme Court of the United States ruled on January 15 that shareholders cannot look to third parties for recovery from fraud unless the investors can show that they relied on information from these "secondary actors" in making their investment decisions. The determination by the Court can only be changed by an act of Congress, which currently has no plans to pursue a legislative remedy. The case, *Stoneridge vs. Scientific Atlanta*, involved substantially similar issues underlying larger cases against Enron and WorldCom, and the Court followed its decision in *Stoneridge* with a one-sentence dismissal order of *Regents of the University of California vs. Merrill Lynch* (the Enron case) on January 22.

Court conservatives Samuel Alito, John Roberts, Antonin Scalia, and Clarence Thomas were joined by moderate Anthony Kennedy, who wrote the decision, for a 5-3 ruling. The majority wrote that allowing such shareholder suits "may raise the cost of being a publicly traded company under our law and shift securities offerings away from domestic capital markets," echoing the position of the Bush Administration, which advocated for the view that won out. Justice John Paul Stevens joined with Ruth Bader Ginsberg and David Souter, who countered that shareholder suits are an important part of preserving faith in and integrity of the markets. The remaining Justice, Steven Breyer, recussed himself from the case because of an indirect ownership interest in Scientific Atlanta.

The *Stoneridge* case involves vendors who assisted the company in recording phantom transactions to cover up a revenue shortfall. In the Kennedy-scribed opinion, he wrote that the link between vendor and company is "an indirect chain that we find too remote for liability" for the third parties. The majority opinion notes that the Securities and Exchange Commission (SEC) remains free to pursue third parties it deems culpable for abetting corporate fraud, and that enforcement by the agency is preferable to litigation. Lawyers are also pouring over the decision to see if enough of a distinction exists between vendors, who seem clearly excluded from virtually all shareholder suits, and third parties in the financial field where the argument that shareholders “rely” on their information may be stronger. The ability to sue secondary players in corporate fraud is often called “scheme liability.”

Some have called on Congress to repair what they see as a mistaken ruling by the Court. The *Los Angeles Times*, for example, wrote in an editorial that “it's up to Congress to create a meaningful deterrent to such schemes before Wall Street bankers try again to make foundering money pits look like fast-growing businesses.” The *Times* also points out that, while the SEC can seek penalties of tens of millions of dollars, those fines are a drop in the bucket compared to the $40 billion investors were seeking for collaborators in the Enron disaster.

At press time, neither the House Financial Services Committee nor Senate Banking Committees had issued statements about what, if anything, these panels intend to do about the ruling.

President Signs Bill with New FMLA Provision; FMLA Changes Proposed

A new defense authorization bill was signed by President Bush, enacting with it an expansion of Family and Medical Leave Act (FMLA) provisions for the families of veterans. The new law gives spouses, children, and parents of a military person the right to unpaid leave to care for a wounded active, reserve, or active National Guard soldier. In addition, the new law creates a right for close relatives of a soldier called up for active duty, or already on active duty, to take up to 12 weeks of unpaid leave to attend to the problems created by deployment of a close family member. The law covers employees with at least 1,250 hours during the last 12 months for an employer with more than 49 workers within 75 miles and allows the worker to take the leave in segments or all at once. The Federal law will trump California’s own on this subject, signed by Governor Schwarzenegger on Oct. 9, 2007.

The Department of Labor will develop more specific guidelines through the rule-making process. President Bush had vetoed the previous version because of his perception that it imposed “financially devastating hardship” on the military in Iraq.

Elsewhere on the FMLA front, the Department of Labor (DoL) has sent clarifying regulations to the Office of Management and Budget (OMB) on aspects of the FMLA deemed unclear by the regulators and in response to perceived abuses of the system by employees. Reports suggest that the new regulations will formalize notification requirements to prevent workers playing fast and loose with the intermittent leave benefit and medical conditions may be subject to stricter standards of proof. Changes may also occur as DoL tightens definitions for “serious medical condition,” a sore spot with some employers who feel the current rules are too permissive.

ERISA Voids San Francisco Law; Implications for State Health Reform

Another court, another outcome as the order to block implementation of the City of San Francisco's universal health plan was itself stayed by the 9th Circuit Court of Appeals. The coverage plan thus can go forward, at least until another court weighs in.

The plan to provide health access to the city's 82,000 uninsured calls for private employers with 20 or more employees and not-for-profits with more than 50 employees to provide health benefits at a minimal level or pay in to a fund to pay for coverage. In December, the courts ruled that the program violated the Federal ERISA law by requiring employer spending on benefits.

Plaintiffs prevailed earlier in their suit against the City of San Francisco, which had proposed mandates on employers to pay for healthcare. City employers with 20 or more workers would have been forced to contribute 15%-20% of payroll, or between $1.06 and $1.60 per hour, beginning January 1, 2008. The earlier court said that "By mandating employee health benefit structures and administration, those requirements interfere with preserving employer autonomy over whether and how to provide employee health coverage, and ensuring uniform national regulation of such coverage." Section 514(a) of ERISA provides the grounds for Federal preemption of "any and all State laws insofar as they now or hereafter relate to any employee benefits plan."

The opinion reiterated that ERISA "indicates Congress's intent to establish the regulation of employee welfare benefit plans 'as exclusively a federal concern.'" However, in the stay order, Circuit Court Judge William Fletcher wrote in the decision to allow the city to proceed that "avoidable human suffering, illness and possibly death will result if a stay is denied."

EEOC Allows Co-ordination of Medicare Benefits without ADEA Violation

The Equal Employment Opportunity Commission (EEOC) produced a rule allowing retiree health plans and Medicare bridge plans to continue without violating the Age Discrimination in Employment Act (ADEA). The rule, stemming from *Erie County Retirees Association v. County of Erie*, brings years of litigation to an end.

According to the summary from the December 26, 2007, Federal Register, "The Equal Employment Opportunity Commission is publishing this final rule so that employers may create, adopt, and maintain a wide range of retiree health plan designs, such as Medicare bridge plans and Medicare wrap-around plans, without violating the Age Discrimination in Employment Act of 1967 (ADEA). To address concerns that the ADEA may be construed to create an incentive for employers to eliminate or reduce retiree health benefits, EEOC is creating a narrow exemption from the prohibitions of the ADEA for the practice of coordinating employer-sponsored retiree health benefits with eligibility for Medicare or a comparable State health benefits program. The rule does not otherwise affect an employer's ability to offer health or other employment benefits to retirees, consistent with the law."

The court disputes have centered on whether providing pre-Medicare age retirees supplementary coverage that ends when Medicare kicks in constitutes an illegal age-based discriminatory practice. The new rule explicitly allows employers to coordinate their retiree health benefit offerings with Medicare without violating the Age Discrimination in Employment Act (ADEA) in what it calls a "narrow" exemption to the ADEA. The Agency has contended that rather than harm older workers, allowing co-ordination of benefits helps to preserve benefits against cutbacks and elimination.

House Committee Holds Hearing on WEP/GPO Legislation

Public employee issues emerged at a hearing before the House Ways and Means Committee on January 16 regarding "Social Security Benefits for Economically Vulnerable Beneficiaries." Members used the occasion to bring up H.R. 82, The Social Security Fairness Act, which has 336 cosponsors in the House and would effectively repeal the Windfall Elimination Provision (WEP) and the Government Pension Offset (GPO) of Social Security for public employees in most cases. Congressman Howard Berman (D-CA, Van Nuys), sponsor of the bill, and Congressman Buck McKeon (R-CA, Santa Clarita) continue to lead the effort on the measure.

The GPO affects an estimated 401,000 Social Security beneficiaries, according to Margaret Baptiste, president of the National Active and Retired Federal Employees' Association. Three-quarters of those facing GPO are women and about half have lost their spouses.

Subcommittee Chairman Michael McNulty (D-NY) agreed that the rules adopted to prevent "double-dipping" and abuse are not having the desired results. McNulty noted that all the proposals have advantages and disadvantages and need to be viewed within the context of Social Security's overall soundness. While recognizing that many affected by WEP/GPO feel it is "unfair," he approached the topic cautiously and said that the Subcommittee should consider offsets for any changes it makes.

Congressman Sam Johnson (R-TX), Ranking Member of the Subcommittee, voiced no sympathy for changes in WEP/GPO. "These provisions of law were enacted to help ensure that workers who pay into a government retirement system outside of Social Security are treated no better than those who work in jobs covered by Social Security" Johnson said in a statement to open the hearing. "To repeal those two provisions of law would be to give an unfair bonus to individuals who work in jobs not covered by Social Security. Also, the repeal of those two provisions would cost taxpayers roughly $80 billion over 10 years." Johnson added that "Public servants, such as teachers, police officers and firefighters, would be given credit for their work in jobs covered by Social Security in the same manner as all other working Americans – no better and no worse."

Congressman Berman countered that "Public employees – teachers, police officers, government workers, and fire fighters – face the loss of a substantial part of their retirement benefits because of GPO and WEP. Although these two provisions were created to help equalize the way workers are treated between two retirement systems, the outcome is a substantial financial hardship for many of our nation's retiring public servants. This is a classic case of the law of unintended consequences hard at work….[T]hese provisions are arbitrary and hurtful. I hope the Subcommittee will continue its investigation of GPO and WEP and will conclude that they should be repealed."

A House vote is not scheduled at this time. The Senate companion, S. 206 by Senator Dianne Feinstein (D-CA) with 34 cosponsors, has also not been acted upon by that body.

California Congressional Delegation

Several Californians are especially worthy of notice during January. Congressman Howard Berman (D-Van Nuys) and Congressman Buck McKeon (R-Santa Clarita) maintained their efforts to reform the Windfall Elimination Provision (WEP) and the Government Pension Offset (GPO) for retirees from public service.

Speaker Nancy Pelosi (D-San Francisco) earned plaudits for forging a deal on the stimulus plan with President Bush and House Republicans in record time, even if the emergency legislation is now somewhat delayed by Senate consideration.

House Oversight and Investigations Committee Chairman Henry Waxman (D-Beverly Hills/Malibu) kept the heat on corporate pay by asking CEO's of companies embroiled in the subprime lending disaster to discuss the rewards system at their companies, and invited the chairmen of the respective compensation committees to testify as well.

Related National and Industry News

Last SEC Democrat Leaves at End of January

Anne Nazareth, the only remaining Democrat on the five-member Securities and Exchange Commission (SEC), left her post at the end of January. The other Democrat, Roel Campos, left the Commission in September.

Subsequent to Campos' exit, Nazareth was the sole dissenting voice when the SEC considered whether shareholders should have access to the company proxy. The position generally regarded as anti-shareholder prevailed on the votes of the two Republican commissioners and the SEC chairman, Chris Cox, formerly a Republican Congressman from Southern California.

The law requires three of five commissioners come from the President's party and the remaining two from the opposing party. The President must still approve the other two commissioners and all five positions require Senate confirmation. A lengthy vetting process precedes a formal nomination to the Senate and there is no clear estimate on when the Administration will be ready to send candidates to the Senate to restore the five member commission to full strength. White House spokesman Gordon Johndroe said that "The president hopes to fill the positions soon."

The current choices to replace Campos and Nazareth are Elise Walter of the Financial Industry Regulatory Authority (FINRA), the organization created by the merger of the enforcement divisions of the NYSE and NASD in July of last year, and Luis A. Aguilar, a corporate lawyer who previously worked for INVESCO and has substantial experience in Latin American business. Senate Majority Leader Harry Reid (D-NV) sent the two names up for White House review in November of 2007.

DC Plans Lower Retiree Replacement Income: CRR

The Center for Retirement Research (CRR) issued a report (available online) suggesting that potential retirees have lost ground by about every measurement during the recent period of ascendency of the DC plan. The Center studied retirement income from 1992 to 2004. The typical head of household 51-56 years of age – part of the so-called retirement “red zone” when personal finances need to prioritize retirement savings – had $114,000 in pension savings, 11% less than they did in 1992. Given a potential 20 years in retirement, $475 a month may not go as far as hoped.

Many still believe Social Security will continue to supplement private savings for the foreseeable future. However, current trends have complicated the interaction of Social Security with other retirement savings. The report cited the increase in full retirement age from 65 to 67, the share of benefits taxable to the retiree as income under un-indexed tax rules, and (likely most threatening) the projected growth of Medicare premiums that will be deducted from Social Security. All three factors are predicted to diminish the current importance of Social Security, which currently replaces about 40% of average pre-retirement income. The changes in pension dynamics have diminished income replacement from that source by 6%, from 32% in 1992 to 26% in 2004, making erosion of Social Security’s replacement value a troubling development.

While employer provided coverage has changed only minimally, from 62% in 1992 to 66% in 2004, the change from DB to DC coverage has changed the value of those benefits. Although the report’s methodology yields a median DB benefit in 2004 about $1,000 less than in 1992 and a DC benefit $6,000 higher in that period, the DB benefit is still $114,609 versus a DC benefit of $49,626. The report explains: “If defined contribution plans are displacing defined benefit plans, and if defined contributions are on average less valuable, than it is entirely possible for average pension wealth to be declining even when the average balance held in each type of plan is increasing.” Or, as the report concludes: defined contribution balance increases “were not enough to maintain average household benefits and replacement rates at their 1992 levels.”

Despite continued study that generally supports the conclusion that DB plans do a better job at providing basic benefits and DC plans are there to supplement the DB plan, the DC craze shows little signs of abating. Employers have dropped DB plans in favor of DC plans during the period studied, and the DB plan is routinely treated as a dinosaur – majestic and strong perhaps, but living on borrowed time – in both the trade press and Capitol Hill.

Congress, SEC Focus on Exec Pay

Congressman Henry Waxman (D-CA/Los Angeles), Chairman of the House Oversight and Investigations Committee, invited certain leaders of the financial industry to discuss their compensation arrangements. The companies involved include Countrywide Financial Corp., Citigroup, and Merrill Lynch & Co. – all companies deeply involved in the subprime debacle. The hearing is scheduled for February 7. The chairmen of the compensation committees of the companies have also been invited to testify.

As a predictor of the tone for the hearings, the letter to Angelo Mozilo of Countrywide read in part: “According to recent press reports, if Bank of America Corp completes its proposed purchase of Countrywide Financial, you stand to collect tens of millions of dollars in severance payments and other compensation” and whether it and other pay “is justified in light of your company's recent performance and its role in the national mortgage crisis.” Waxman also questioned how such a pay package could be aligned with shareholder interests.

Also on the pay front, the Securities and Exchange Commission (SEC) sent several hundred companies a request for further explanation of their pay practices after its first inquiry came last summer produced unsatisfactory compliance. The SEC has been pressing for companies to explain how the pay packages adopted further corporate goals and did not intend to inspire corporate disclosure to include even more footnotes and charts for their own sake. Previous responses from filers grounded pay on “individual performance,” a standard the Commission considers fuzzy and somewhat arbitrary, the Commission seeks to promote more quantitative measures, such as pay tied to overall company goals like share price, sales growth, or some other measurable factor or reasonable metric.

Critics complain that setting such targets would promote even more short-termism than present today. In line with this thinking, a committee of the U.S Chamber of Commerce called for an end to quarterly earnings statements as a way to re-orient management toward the long term.

Both Congressional and regulator activity provides focus and uncovers data useful for the overall efforts to contain unjustified or arbitrary pay by those most affected by it: the shareholders. As this year’s shareholder campaign for a “say on pay” expands past the 90 companies where proposals have already been filed, continued inquiries from the government should support the efforts in the trenches to bring about reform of the corporate pay process.